

NATIONAL FORECAST DESCRIPTION

The Forecast Period is the Third Quarter of 2008 through the Fourth Quarter of 2011

The next two years will be challenging for the economy. Since the first signs of crisis in the financial markets surfaced in the summer of 2007, the worst fear was the financial crisis and economic slowdown would reinforce each other and tip the economy into a recession. These fears were magnified with the steady stream of dismal economic news and the financial market meltdown this summer. Indeed, Global Insight believes the economy already slipped into a recession in this year's third quarter. The current forecast assumes the recession lasts for three months, with a peak-to-trough decline of 0.6%. The unemployment rate is expected to rise to 7.5%. In summary, this recession is likely to be more like the 1981-82 recession than the mild 1990-91 and 2001 downturns.

The economic evidence for a recession is hard to ignore. Most notably, in its latest GDP report, the U.S. Department of Commerce's Bureau of Economic Analysis (BEA) showed real output shrank 0.3% in the third quarter of 2008—its worst showing since the third quarter of 2001. Part of the disappointing GDP estimate reflects retrenching consumers. The BEA shows consumer spending fell 3.1% in the third quarter—its biggest dip since 1990. This drop occurred as households watched their net worth drop with the stock market, credit becomes harder to get, and their home values decline. Consumers are also worried about job security as they hear of ongoing job losses and watch the unemployment rate rise. Given these factors, it's no wonder consumer confidence is at record lows. Other parts of the economy are also at risk. Export growth is no longer strong enough to keep manufacturing afloat. Housing starts drop below one million units.

Stock markets around the world plunged this fall as the flow of funds through the financial system has, in effect, seized up. The interbank market is not functioning, and the only asset investors seem comfortable holding is government debt. The seizing up of credit is working its way into the broader economy, making it harder for consumers, businesses, and state and local governments to obtain credit. Thus they have cut back on spending, investment, and hiring.

Central banks and governments are trying to stem the panic with every tool possible. The Federal Reserve lowered its federal funds rate to 1.0% on October 29, 2008. However, it has also used less traditional tools. It is now lending directly to nonfinancial corporations. The U.S. Treasury has been given unprecedented powers. Congress passed and the President signed into law the \$700-billion Troubled Asset Relief Program (TARP). The impact on the deficit will ultimately depend on the prices paid for assets compared to the earnings received from the assets and the prices at which they sell. This measure allows the U.S. Treasury to purchase "bad assets" from financial institutions. However, the use of TARP continues to evolve.

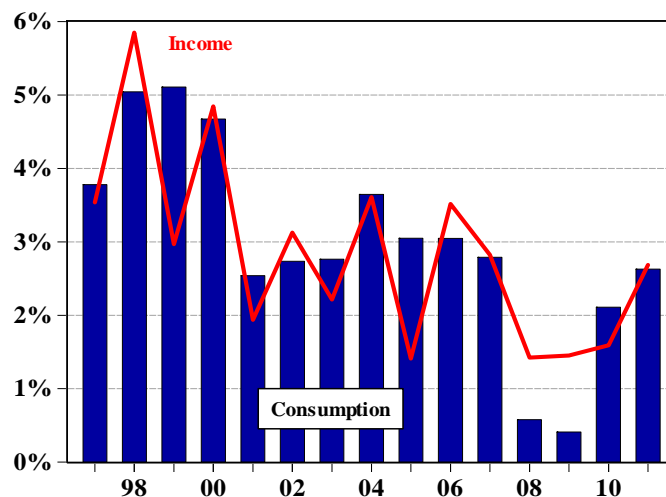
Real GDP is expected to start growing again in the second quarter of 2009. It is forecast to grow slowly at first, remaining under 3.0% growth until the second quarter of 2010. Other closely watched economic measures will take longer to recover. Nonfarm employment will eke out its first gain in the last quarter of 2009, and not grow faster than 1.5% until the beginning of 2011. Real personal income is forecast to drop below 3.0% growth in the second half of 2008 and remain there until late 2009. The economy's stride should pick up in 2011. In that year real GDP expands 3.1%, employment grows 1.7%, and real personal income increases 2.9%.

SELECTED NATIONAL ECONOMIC INDICATORS

Consumer Spending: It appears any light at the end of consumer spending's current tunnel remains dim. The downturn in real consumer spending that began this June will be exacerbated by the deepening financial crisis, as credit availability to finance major purchases is restricted. In a vicious cycle, rising unemployment and falling home prices are driving up credit delinquency and foreclosure rates. The automotive market has been particularly hard hit, as annual sales have dropped to a 16-year low of 12.9-million units in the third quarter—down 19% from the previous year. Spending on home furnishings, clothing, restaurant meals, and personal care products has also fallen off in recent months. It is estimated real consumer spending fell at a 2.8% pace in this year's third quarter—its first quarterly drop since 1991. A further spending drop is predicted for the last quarter of 2008.

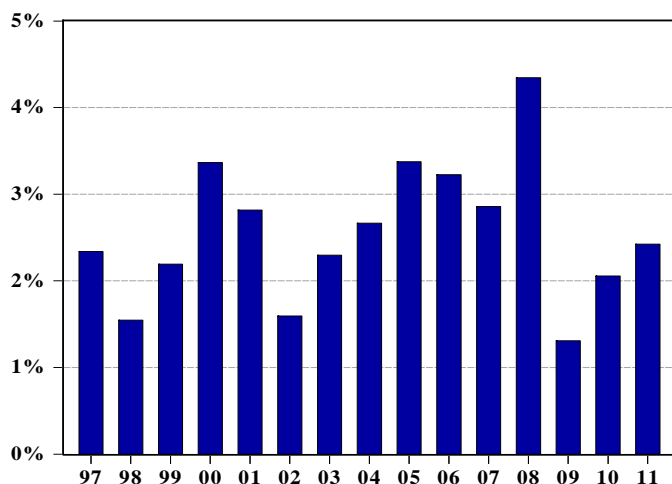
Consumers are facing the multiple headwinds of declining employment, losses on housing and financial assets, and tightening credit. Even the benefits of falling energy prices cannot offset the drag of these factors. The recent stock market plunge brings the cumulative loss in household net worth since the summer of 2007 to nearly \$7 trillion, or about 12%. This drop is comparable to the 2000-02 setback caused by the high-tech implosion. It has been estimated that this will reduce spending by \$350 billion. In order for real spending to recover, the housing market must stabilize and credit markets must improve. It is anticipated real consumer spending will begin its gradual recovery in late 2009 and early 2010. Real spending is forecast to grow just 0.6% in 2008 and 0.4% in 2009. After those years, spending will advance 2.1% in 2010 and 2.6% in 2011. The number of light vehicle sales is expected to decline both this year and next, and then climb to 15.5 units in 2011. After plunging over 12% in 2008, real household net worth will rise over the forecast period, but not enough to reach its 2007 level.

U.S. Real Consumption and Disposable Income Growth



Source: Global Insight

Consumer Price Inflation



Source: Global Insight

Inflation: The inflation situation has improved, which has provided the Federal Reserve more options to respond to the financial meltdown and the recession. With energy prices retreating, the fears of runaway inflation have receded. The gloomy economic outlook caused the price of West Texas Intermediate (WTI) to drop 11% in September and fade to below \$80 per barrel in the first part of October. Gasoline prices spiked in mid-September as Hurricane Ike badly disrupted refinery operations and sent inventories plummeting. However, supplies have improved in recent weeks, and prices have fallen as a result. On an annual basis the price of oil is expected to be about \$108 per barrel in 2008, \$90 per barrel in 2009,

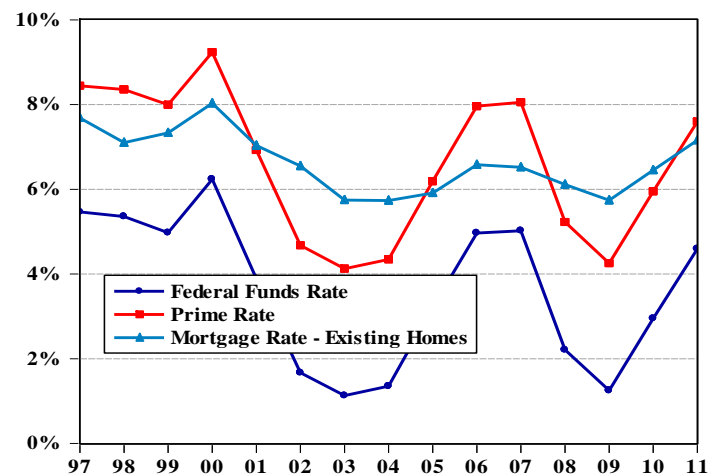
\$92.00 per barrel in 2010, and \$102 per barrel in 2011. The price per gallon of gasoline at the pump is expected to go from \$3.52 this year to \$3.17 next year, to \$3.30 in 2010, and to \$3.50 in 2011. Despite this improvement, cause for concern remains. Core personal consumption expenditure (PCE) inflation in August was 2.6% above the previous year, which is well outside the Federal Reserve's comfort zone of 1.5% to 2.0%. While it is cause for concern, it is not cause for alarm. A return to 1970s-style wage-price spirals is unlikely given the weak job outlook. The continually improving inflation fundamentals mean a further and faster decline in core consumer inflation than had been estimated previously. Core PCE year-over-year inflation drops from 2.5% to 2.4% during the final two quarters of this year, and then falls to 1.6% in the fourth quarter of 2009. Long-term inflation expectations remain anchored and keep core PCE inflation below 2.0% into 2012. Overall inflation, as measured by the consumer price index, is forecast to be 4.3% in 2008, 1.3% in 2009, 2.1% in 2010, and 2.4% in 2011.

Financial Markets: "Drastic times demand drastic measures" seems inadequate to describe recent events in the financial sector. Financial market pressures continued to escalate this fall, with major pressure points in both U.S. and European markets. In response, Congress passed and the President signed into law the \$700-billion Troubled Asset Relief Program (TARP). The impact on the deficit will ultimately depend on the prices paid for assets compared to the earnings received from the assets and the prices at which they sell. This forecast assumes the program will incur a loss of \$165 billion, and this amount has been added to the fiscal 2009 federal budget deficit. This measure allows the U.S. Treasury to purchase "bad assets" from financial institutions.

However, the use of TARP continues to evolve. It now seems that TARP will be used not just to remove illiquid assets from balance sheets, but also as a vehicle to inject capital into banks. The Federal Reserve has massively ramped up efforts to provide liquidity to the marketplace, and it took further steps to support the commercial paper market by adding a loan program for banks to purchase asset-backed commercial paper, plus a more recently announced program to directly purchase commercial paper from the marketplace. As a result of this wide array of programs, the Federal Reserve is expected to expand its balance sheet by about \$600 billion (66%), supported by an expansion of its account at the U.S. Treasury. The nation's central bank has also resorted to a more traditional method of keeping the economy going. In early October it reduced its federal funds rate by 50 basis points to 1.50% followed by another 50-basis point cut at the end of the month. The Federal Reserve is able to cut more aggressively thanks to easing inflationary pressures.

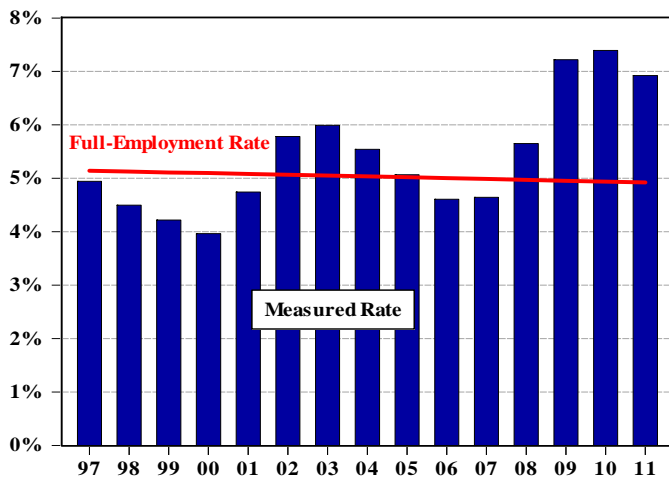
Employment: Nonfarm employment has declined in every month this year, and it is expected to continue falling through most of next year before experiencing an anemic recovery. Nonfarm employment decreased by 159,000 in September—more than twice as much as the average (75,000 jobs) for the previous eight months and its biggest monthly decline since March 2003. And the situation was even worse than the reported numbers because September's decline does not include the 27,000 striking Boeing workers. They were excluded because the strike started after the September survey week. However, they will be included in the October numbers. So far this year, a total of 760,000 jobs have

Selected U.S. Interest Rates



Source: Global Insight

U.S. Civilian Unemployment Rate



Source: Global Insight

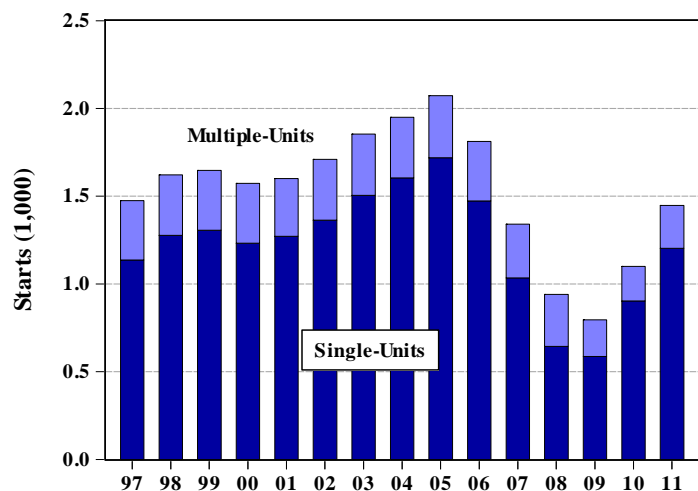
to rise steadily to a peak of 7.5% at the end of next year and remain there through the first half of 2010. As a result of the weak labor market, the employment cost index growth is expected to drop below 3.0% percent during the last three years of the forecast. This slowdown in employment costs should help keep a lid on future inflation.

Housing: Signs of the housing industry's recovery remain elusive. The fundamental problem is the inventory overhang, which is contributing to falling house prices and rising foreclosures. In addition, housing's outlook has dimmed because of the financial markets turmoil. Housing starts are forecast to slide during 2008, and slip beneath the 1-million-unit mark this year for the first time since 1945, and drop to 800,000 units in 2009. Housing starts hit bottom (738,000 units) in the second quarter of 2009. On an annual basis, there are expected to be 941,000 starts in 2008, 796,000 starts in 2009, 1,099,000 starts in 2010, and 1,448,000 starts in 2011. Given the drag from housing starts, residential investment is expected to reduce real GDP growth by about one percentage point this year and one-half percentage point in 2009. The existing home market is feeling downward pressures from several sources. These factors include tight credit, job losses, falling real home prices in most metro areas, and low consumer confidence. Thus, despite a recent leveling of sales, it is anticipated existing home sales will fall from 4.8 million units in 2008, to 4.5 million units in 2009, then rise to 4.6 million units in 2010, and to 5.2 million units in 2011. Housing prices will also continue falling because inventory levels remain near record highs and foreclosures are still rising. As a result, the median price of an existing home is expected to drop 17% from the second quarter of this year to

been lost this year. Another symptom of the ailing labor market is private hours worked dropped 0.5%. The U.S. civilian unemployment rate in September was 6.1%. While it is unchanged from the previous month, it is 1.4 percentage points above its year-ago level. Unfortunately, things are forecasted to get worse. On a cumulative basis, the job market's decline is only about one-third of the way done. That is, nonfarm payrolls are forecast to fall by more than 2.1-million jobs peak to trough during this recession. After suffering back-to-back losses in 2008 and 2009, employment should grow by under 1.0% in 2010 and 1.7% in 2011. At this pace, the number of jobs lost is not recovered until the beginning of 2011.

The civilian unemployment rate is forecast

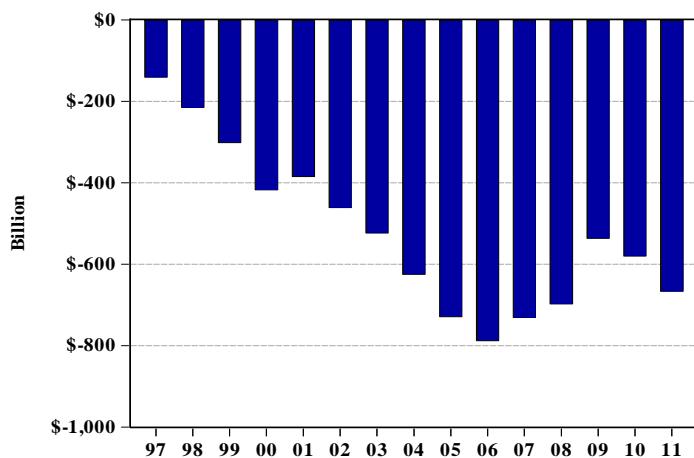
U.S. Housing Starts



Source: Global Insight

its nadir in early 2009. The median price of an existing home is forecast to decline 8.9% in both 2008 and 2009, advance just 0.8% in 2010, and rise 4.3% in 2011.

U.S. Current Trade Deficit



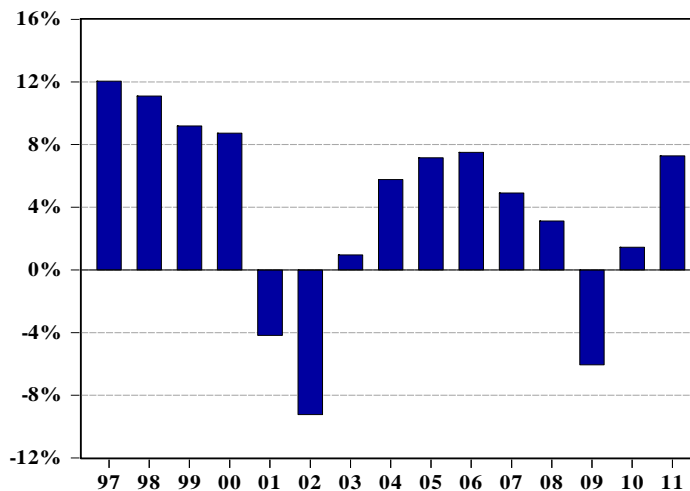
Source: Global Insight

International: The global economy is expected to cool over these next two years, with the biggest hit coming in 2009. Specifically, the world's real economic output is forecast to go from 3.9% in 2007 to 2.8% in 2008 then to 2.1% in 2009. United States economic growth is forecast to down shift from 2.0% in 2007 to 1.5% this year and then nearly stall at 0.2% next year. However, the United States will not suffer alone. Japan is expected to eke out just 0.6% growth in 2008 and 0.4% growth in 2009, which is down from its 2.0% gain in 2007. European economic growth, which enjoyed a 2.6% pace in 2007, is anticipated to slow to 1.1% in 2008 and 0.4% in 2009. Two of the United States'

closest trade partners, Mexico and Canada, are hard hit by the global slowdown. Mexico's output growth is projected to drop from 3.2% in 2007 to 1.8% in 2008 and 1.0% in 2009. After growing 2.7% in 2007, Canadian real GDP is forecast to advance by less than one percent in both 2008 and 2009. South America should grow 4.9% this year and 3.7% next year. Asia except for Japan will remain the strongest growing region, but it will not be immune from the global slowing. This region's economy advanced 8.3% in 2007, but will grow "just" 6.8% in 2008 and 6.1% in 2009. China will be the economic growth champion, even though it is expected to slow from last year's nearly 12% pace to 9.8% in 2008 and 8.4% in 2009. Net exports are expected to improve over these two years as exports rise and imports fall. The latter reflects a huge decline in the country's petroleum import bill that is expected to drop 15.8% from 2008 to 2009. On the balance of payments basis, the U.S. current account deficit is expected to be \$698 billion in 2008, \$536 billion in 2009, \$580 billion in 2010, and \$666 billion in 2011.

Business Investment: The deteriorating conditions in the financial markets do not bode well for business investment. After being boosted by recent surges in oil drilling and in manufacturing construction, nonresidential construction is expected to begin a seven-quarter slump, where most categories decline at double-digit rates in 2009. The credit crunch will hit businesses hard. They will find it difficult to finance some projects and opt to preserve cash rather than finance projects. Spending on equipment and software will struggle in this environment. Real equipment and software spending is expected to increase in the fourth quarter, as businesses race to take advantage of the accelerated depreciation

Real Business Investment



Source: Global Insight

packages that were part of last winter's stimulative package. However, it drops in the following quarter—payback for the fourth-quarter binge—and should drop again in the second quarter. On an annual basis, real investment on equipment and software is expected to drop 0.5% in 2008 and then by 2.8% in 2009. After suffering two years of decline, equipment and software investment increases 5.5% in 2010 and 8.7% in 2011. In the aggregate, nonresidential fixed investment is forecast to increase 3.1% this year, plunge 6.1% next year, rise 1.4% in 2010, and expand 7.3% in 2011. It is important to keep in mind that given recent uncertainties in financial markets business investment could be hit harder. Specifically, it has been calculated real spending on equipment and software could drop nearly 11% in 2009 and business investment could decline 12.4% under the assumptions of Global Insight's *Pessimistic Scenario*.

Government: The federal unified budget deficit is projected to come under substantial pressure in fiscal years 2009 and 2010, the results of slower revenue growth and higher expenditures. The cooling economy causes federal revenue to increase a meager 0.2% in 2009 and advance 5.1% in 2010. The bump in federal government expenditures results from two sources. The first is the Troubled Asset Relief Program (TARP). It is anticipated this program will incur losses with a present value of about \$165 billion, which has been added to the 2009 federal budget deficit. Second, it is assumed the federal government will enact another round of fiscal stimulus to help kick start the economy. It is assumed to be a \$50 billion package that will be implemented soon after the new president is elected. It includes \$10 billion in extra transfer payments, \$15 billion in extra transfers to the states to support Medicaid, and \$25 billion in funding for infrastructure spending. This additional spending starts in the second half of 2009 and lasts through 2010. Under these conditions, the federal unified budget deficit goes from \$406.4 billion this year, to \$786.6 billion next year, to \$592.3 billion in 2010, and to \$504.3 billion in 2011.